July 23, 2012

Wallace's Daily Policy Debrief

Today:

1) **Weekly Central Bank Report – Tom Gallagher**
2) **Policy Calendar**

Macro Briefs: Fed Outlook, Dividend Taxes

The Fed seems likely to ease further at one of the next two meetings.

This results from a combination of recent Fed commentary, continued data disappointments, and the weak stock market.

- Some market participants were disappointed by Bernanke's failure to provide some hints at further action. But he rarely does so when he is presenting the Fed's semi-annual report on monetary policy – he is essentially obligated to present the views from the last FOMC meeting where the report was approved. **More important, what strikes us is that core FOMC members who are speaking publicly are not defending the current stance of policy as much as stressing a willingness to do more if the data disappoint.** That is a condition highly likely to be met.

- The minutes of the June meeting indicated several members were interested in exploring new policy options. That's because of diminishing returns to existing easing actions, and of course there are no rabbits to be pulled out of the Fed's collective hat. **Thus, while some observers may get excited about this passage in the minutes, it's better read as a measure of frustration with the relatively limited impact of options currently before the Fed.**

- **Bernanke did put a cut in the Interest on Excess Reserves (IOER) rate on the menu, but few expect the Fed to order it.** This option has been highlighted now that the ECB cut its deposit rate (the parallel rate for the Fed's IOER rate). The ECB has reasons to do this (discouraging intermediation of funds through the ECB) that don't apply to the Fed, and the US financial system is more reliant on money market funds than in Europe. Notably SF President Williams indicated in his Financial Times interview he did not support this move.

- Williams also was cool toward another option, a BOE-like plan to lend to banks that in turn increase lending to households and firms (although Bernanke did include using the Fed's discount window as a potential easing option, which might be used in a fashion comparable to the BOE move). Williams also preferred the next round of QE to focus on MBS rather than Treasuries.

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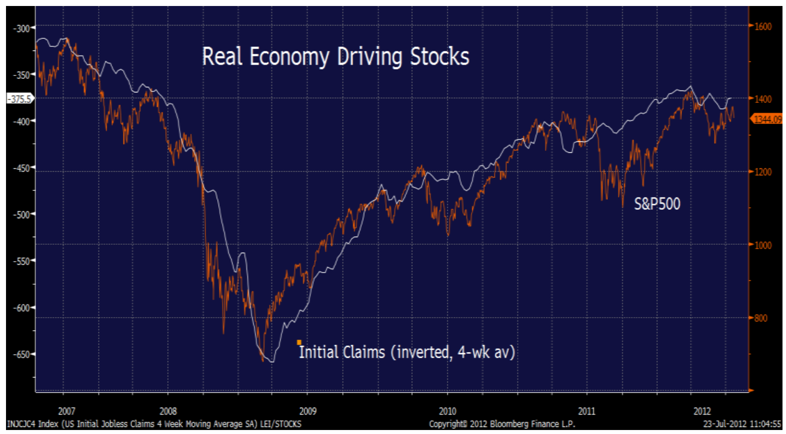
- **Most interesting from Williams was a suggestion that the Fed should get away from fixed rounds of QE and have an open-ended asset purchase program geared toward macro variables** (e.g., $100 billion per month until the unemployment rate forecast reaches some level). That doesn't seem like a near-term option, but it introduces a more aggressive option into the mix. If Bernanke wanted to surprise markets and exceed expectations, this is the kind of thing he could turn to.

- **We think the Fed would rather not act at next week's meeting, but if data or markets force their hand they could extend the rate guidance, conditionally promising to keep rates near zero to mid-2015 from the current late-2014.** Other variations on the rate guidance are also possible. But that's as far as we could see the Fed go next week.

- **If the Fed engages in more QE, it would likely wait for the September meeting, when it will have the benefit of more economic data, including two more employment reports.** Even then, there is a higher threshold due to the presidential election campaign, but recent commentary from FOMC members does not suggest this is an insurmountable hurdle.

We don't think the stock market has gotten ahead of the Fed.

We've run this chart a few times before. It shows that the stock market has tracked initial unemployment claims pretty well, with clear deviations around heightened Eurozone risk in mid-2010, mid-2011, and recently. Arguably in a deleveraging environment, the market has a hard time getting visibility on the economic outlook and thus tracks a timely coincident indicator like claims. To be clear, hints of new Fed easing would be positive for the market in the short-term, but the trend of the market is going to be driven by the economy. (This chart is also a good argument against the notion that the market is being held up to unsustainably high levels by Fed policy.)



Senate Democrats offered an important signal on dividend taxes last week.

Majority Leader Reid (D-NV) last week introduced legislation to extend the 2001 and 2003 tax cuts for those making under $250,000 (those making more than $250,000 would pay pre-2001 rates). The bill is to be the basis of votes on tax policy in the next few weeks, intended to contrast the Democratic position with the Republican position of extending all of those cuts for all taxpayers. As such, the debate is about drawing bright lines. Thus it's notable that the one exception Senate Democrats made for the repeal of tax cuts for those making more than $250,000 was that dividend taxes would be capped at 20%, which was the pre-2001 rate for capital gains, rather than reverting to 39.6%, which was the top dividend rate before 2001.

Thus, in a highly charged election environment, Senate Democrats are choosing to keep dividends and capital gains both at the same rate and at a preferred rate relative to ordinary income. That strongly suggests that even under a good election outcome for Democrats (Obama is re-elected and Democrats hold on to the Senate), the top rate on dividends won't go above 20% in 2013 (this would be the top statutory rate on dividends; the new investment income surtax of 3.8% for high-income earners included in health care reform takes effect next year and has to be added to get a top effective marginal rate of 23.8% for both dividends and capital gains).

- Tom Gallagher

Policy Calendar

Highlights for the Week

- ECB/EC/IMF team continues evaluation of Greece's financial assistance terms (T)
- European Commission proposes changes to financial market abuse rules, including LIBOR procedures (W)
- Treasury Secretary Geithner testifies at House Financial Services Committee on financial stability, LIBOR, EU debt crisis and more (W)
- House Agriculture Committee hearings on swaps markets oversight (W)
- CFTC's technology advisory committee meets to consider new methods for SRO oversight of customer accounts at swaps market firms (Th)

Monday

- Federal Reserve Board Governor Bloom Raskin speaks at the University of Colorado's Graduate School of Banking
- CBO re-estimates 10-year budget implications of the Affordable Care Act
- John Kay's final report on UK equity markets and long-term decision-making implications for companies and savers

Tuesday

- 4am EDT, ECB/EC/IMF team continues evaluation of Greece's financial assistance terms
- 8:15 am, ISDA begins conference examining Dodd-Frank swaps rules
- 10am, Apple v. Kodak in bankruptcy court over ownership of 10 patents
- 10am, FHFA House Price Index
- 10am, House Financial Services subcommittee hearing on consumer credit access
- 10:30am, ECB's Noyes testifies at French parliament
- 2:30pm Senate Banking subcommittee hearing on private student loans
- UN Security Council and Iranian technical experts resume talks in Istanbul

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This Week's Central Bank Meetings

Monday, July 23

Israel

- Current bank rate: 2.25% (1.25% real rate)
- Last policy change: 6/25/2012 (-25bps)

Tuesday, July 24

Hungary

- Current base rate: 7.00% (1.40% real rate)
- Last policy change: 12/20/2011 (50bps)

Wednesday, July 25

Thailand

- Current repo rate: 3.00% (0.44% real rate)
- Last policy change: 1/25/2012 (-25 bps)

New Zealand

- Current cash rate: 2.50% (1.50% real rate)
- Last policy change: 3/10/2011 (-50bps)

Guatemala

- Current leading rate: 5.00% (1.53% real rate)
- Last policy change: 7/25/2012 (-50bps)

Thursday, July 26

Egypt

- Current deposit rate: 9.25% (1.95% real rate)
- Last policy change: 11/24/2011 (100bps)

Friday, July 27

Colombia

- Current overnight rate: 5.25% (2.05% real rate)
- Last policy change: 2/24/2012 (25bps)

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Last Week's Central Bank Meetings (Summary)

Country/Region	Key Rate	Other Actions
Canada	Unchanged at 1.00%	
South Africa	-50bps to 5.00%	
Turkey	Unchanged at 5.75%	
Mexico	Unchanged at 4.50%	

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